In the Supreme Court of the United States

OCTOBER TERM, 1966

No. 893

SNYDER BROTHERS COMPANY, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

This case presents the frequently recurring question whether a transfer of property by two stockholders to their wholly owned corporation created an "indebtedness" within the meaning of § 163(a) of the Internal Revenue Code of 1954, so that periodic payments by the corporation are deductible as "interest."

The two Snyder brothers operated a manufacturing business as equal partners. In 1957 they transferred all the partnership's assets to a newly formed

corporation (petitioner) in exchange for $100,000 of common stock, $140,000 of subordinated debentures, and the corporation's agreement to assume the partnership's $202,500 of liabilities. Under the terms of the subordinated debentures, the principal of $140,000 was payable in 20 years with six percent interest payable semiannually. However, payment of both principle and interest was subordinated to all other indebtedness of the corporation, whether already existing or incurred thereafter, without any limitation on the incurring of future debts. Moreover, there was also no limitation on the payment of dividends to stockholders, and no provision accelerating the maturity of the principal upon a default in interest payments. Finally, in case of any default in payment of either interest or principle on the subordinated debentures, all other indebtedness of the corporation would become immediately due and payable upon demand, regardless of the expressed maturity thereof, and would be entitled to payment in full before the holders of the subordinated notes received any payment. (Pet. A2, A13-16.)

The Commissioner took the position that the subordinated debentures were actually equity investments in the nature of preferred stock rather than "indebtedness" within the meaning of Code § 163, so that the so-called "interest" payments were actually non-deductible dividends. The district court directed a verdict for petitioner. The court of appeals reversed and directed entry of judgment in favor of the government. (Pet. A3-A4).

1. It is well established that dividends paid by a corporation on common or preferred stock are not deductible, but that interest paid by a corporation on "indebtedness" qualifies for a deduction. It is also clear that the incidence of taxation generally depends on the substance of a transaction and not on the label adopted by the parties. See, *e.g.*, *Gregory* v. *Helvering*, 293 U.S. 465; *Griffiths* v. *Commissioner*, 308 U.S. 355; *Higgins* v. *Smith*, 308 U.S. 473; *Commissioner* v. *P. G. Lake, Inc.*, 356 U.S. 260; *Knetsch* v. *United States*, 364 U.S. 361. This principle applies equally in the debt-versus-equity area. See, *e.g.*, *Foresun, Inc.* v. *Commissioner*, 348 F. 2d 1006, 1008 (C.A. 6); *Gilbert* v. *Commissioner*, 248 F. 2d 399, 402-404 (C.A. 2). Thus, a taxpayer who has transferred money or property to his corporation in exchange for what is in essence preferred stock cannot convert the periodic dividends into deductible interest merely by changing the label on the certificate. Especially where (as here) the so-called "debt" is issued to the stockholders in exactly the same proportion as their stock ownership in the corporation, the courts have subjected the transaction to careful scrutiny. *E.g.*, *Charter Wire, Inc.* v. *United States*, 309 F. 2d 878, 880 (C.A. 7), certiorari denied, 372 U.S. 965; *Arlington Park Jockey Club* v. *Sauber*, 262 F. 2d 902, 906 (C.A. 7). In fact, the courts have often concluded that a debt instrument which on its face appeared to have rights substantially different than preferred stock (*e.g.*, short maturity, no subordination, etc.) was, in light of the surrounding facts and circumstances, not entitled to any different treatment than preferred stock.

E.g., P. M. Finance Corp. v. *Commissioner*, 302 F. 2d 786 (C.A. 3); *Gooding Amusement Co.* v. *Commissioner*, 236 F. 2d 159 (C.A. 6), certiorari denied, 352 U.S. 1031.

In this case it is unnecessary to review all of the standards used in deciding whether shareholder notes which on their face are pure debt instruments actually do not constitute "indebtedness" within Code § 163, for (as the lower court held) the subordinated debentures here in question "go farther towards eliminating any difference between the holders of these debentures and preferred stockholders than any case that has been called to our attention" (Pet. A8). The entire $140,000 of subordinated debentures were issued to the Snyder brothers—the corporation's sole stockholders—in exact proportion to their stockholdings. These debentures are for a long term (20 years), they are unsecured, there is no sinking fund and no limitation on the amount of dividends the corporation can pay, the principal amount does not become due before the end of 20 years even if the corporation defaults in the payment of interest, and the debentures are completely subordinated to every other debt incurred by the corporation over the entire 20 year life.[1]

Moreover, even these minimal protections to the debenture holders are misleading. If the corporation ever defaults in the payment of any interest on the

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[1] Since the lower court's decision depends solely on the rights which the debenture agreement afforded to their holders, the Snyder brothers subjective intent is not an issue in the case, and, contrary to petitioner's repeated assertions (Pet. 2, 9, 14, 16), the government has made no concession with regard to their subjective intention or motivation.

debentures, all of its other debts immediately become due and payable ahead of the debentures. Therefore, if the corporation were to ask the debenture holders to extend the due date for an interest or principal payment, there would be strong pressure on the holders to do so, for, if they refuse and the corporation defaults on the payment, all of its other debts will immediately become due and payable ahead of the debentures.

The court below properly concluded that to construe the subordinated debentures as representing an "indebtedness" within the meaning of § 163—and thus to give a deduction for "interest" paid on these debentures while denying a deduction for fixed dividends paid on preferred stock—would be to give substance to a transaction which upon its face lies outside the plain intent of the statute (Pet. A12).

2. The decision below does not conflict with *John Kelley Co.* v. *Commissioner*, 326 U.S. 521. In *Kelley* this Court declined to pass on the question here in issue, saying that under the then applicable *Dobson* rule the appellate courts should accept the Tax Court's decision on such matters, since the expertise of the Tax Court judges lay "primarily in their ability to examine relevant facts of business to determine whether or not they come under statutory language." 326 U.S. at 529.[2]

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[2] The *Dobson* rule, limiting the scope of appellate review of Tax Court decisions, has since been overruled by Congress. See 26 U.S.C. § 7482(a), making the decisions of the Tax Court reviewable by courts of appeals in the same manner as decisions of the district courts.

There is no conflict between the decision below and the cited decisions of the Court of Appeals for the Second Circuit (Pet. 10). The subordination provisions in the cited cases were more limited than in the instant case.[3] Moreover, in *Commissioner* v. *O.P.P. Holding Corp.*, 76 F. 2d 11 (C.A. 2), upon which petitioner heavily relies, the corporation obligated itself to pay no dividends so long as any interest payment was in default. Here, on the other hand, even after a default in an interest payment the debenture holders could not prevent petitioner from paying dividends (as long as petitioner was not insolvent).[4]

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[3] If for any reason petitioner does not make an interest payment on the subordinated debentures when due, it is under contractual obligation to notify all of its existing creditors; and all of its outstanding debts, whether of later maturity date or not, automatically became due and payable before any payments can be made to the debenture holders. Thus, even if petitioner is not insolvent or in the process of liquidation, the debenture holders have no assurance that they can collect a payment due under the debentures without forcing the petitioner into liquidation in the sense that it will be required to raise sufficient cash to pay off all its existing creditors. Moreover, since the due date of the debentures is not accelerated in case of a default in an interest payment, a debenture holder would be compelled to require the corporation to pay off all of its existing creditors in order to enforce a single interest payment.

[4] Petitioner's statement (Pet. 12) that the corporation could not pay dividends while in default in the payment of interest on the debentures is incorrect. The textual authority relied on by petitioner (Pet. 12, fn. 22), 11 Fletcher, *Cyclopedia Corporations* (1958 Rev.), § 5324, and the cases cited therein hold only that a corporation cannot declare dividends when it is insolvent or when it will thereby become insolvent.

Finally, the Second Circuit has recently taken a more realistic approach to the determination of whether or not a note constitutes indebtedness for tax purposes. In *Nassau Lens Co.* v. *Commissioner*, 308 F. 2d 39, 46, 47 (C.A. 2), the court stated that "non-arm's-length loans by a stockholder to a corporation are to be recognized or disregarded for tax purposes according to the extent to which they comply with arm's-length standards"; the court will inquire "whether outside investors would have made similar advances," and treat a shareholder loan as "indebtedness" only if it "can be said to be debt in terms of substantial economic reality." It is apparent that no outside creditor would have made twenty-year advances to petitioner corporation on the unsecured, subordinated terms contained in the debentures that were issued to its stockholders. Thus, there is no conflict between the instant decision and the decisions of the Second Circuit.

There is no other reason for further review. The decision does not hold, as petitioner contends (Pet. 15-16), that subordinated debt that is issued to stockholders can never constitute indebtedness for tax purposes. The court of appeals held only that where the subordination provisions are so broad that, when combined with the other circumstances that are here present, the position of a holder of the instrument is not substantially different from that of a preferred stockholder, the instrument does not constitute indebtedness in the practical reference of federal taxation.

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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